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IN THE MATTER OF THE APPLICATION OF
TUCSON ELECTRIC POWER COMPANY FOR
THE ESTABLISHMENT OF JUST AND
REASONABLE RATES AND CHARGES
DESIGNED TO REALIZE A REASONABLE RATE
OF RETURN ON THE FAIR VALUE OF ITS
OPERATIONS THROUGHOUT THE STATE OF
ARIZONA.

Docket No. E-01933A-12-0291

**NOTICE OF FILING DIRECT
TESTIMONY**

Pursuant to the requirements of the September 6, 2012 Procedural Order in this matter,
attached are the original and 13 copies of the Direct Testimony of Gary Yaquinto on behalf of
the Arizona Investment Council. Your assistance is appreciated.

RESPECTFULLY SUBMITTED this 21st day of December, 2012.

GALLAGHER & KENNEDY, P.A.

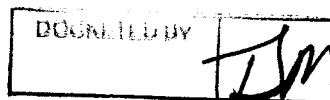
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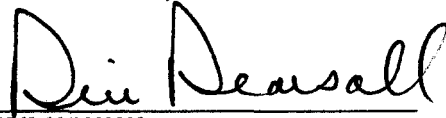
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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE, Chairman
BOB STUMP
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IN THE MATTER OF THE APPLICATION OF
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OPERATIONS THROUGHOUT THE STATE OF
ARIZONA.

Docket No. E-01933A-12-0291

Direct Testimony of

Gary Yaquinto

on Behalf of

Arizona Investment Council

December 21, 2012

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I. QUALIFICATIONS

21 **Q. Please state your name, position and business address.**

22 A. Gary M. Yaquinto. I am the President of the Arizona Investment Council ("AIC"). Our
23 offices are located at 2100 North Central Avenue, Phoenix, Arizona 85004.

24 **Q. Please summarize your educational background and professional experience.**

A. I earned B.S. and M.S. Degrees in Economics in 1974 from Arizona State University, as
well as an MBA from the University of Phoenix in 2005. From 1975 to 1977, I was
employed by the State of Wyoming as an economist responsible for evaluating the
economic, fiscal and demographic effects of resource development in Wyoming. From
1977 to 1980, I was Chief Research Economist for the Arizona House of Representatives.
From 1980 to 1984, I was employed as an economist in the consulting industry. Since
1984, I have worked in various capacities in government and the private sector in the area
of utility regulation, including positions with the Utilities Division Staff of the Arizona
Corporation Commission, a competitive local exchange telephone carrier and as a
consultant. I also served as the Chief Economist at the Arizona Attorney General's
Office from 2003-2005 and as the Director of the Office of Strategic Planning and
Budgeting from 2005-2006. I became AIC's President in December of 2006.

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II. ARIZONA INVESTMENT COUNCIL ("AIC")

Q. What is the Arizona Investment Council and what is its mission?

A. The AIC is a non-profit association organized under Chapter 501(c)(6) of the Internal
Revenue Code. AIC's membership includes approximately 6,000 individuals – many of

1 whom are debt and equity investors in Arizona utility companies and other Arizona
2 businesses.

3
4 AIC's mission is to advocate on behalf of its members' interests primarily before
5 regulatory bodies as well as the Legislature and, specifically, to enlarge and maximize the
6 influence of utility investors on public policies and governmental actions that impact
7 investors and their investments.

8
9 AIC also works with the Commission and policymakers generally to support investment
10 in Arizona's essential backbone infrastructure as well as improvements to, or remediation
11 of, existing facilities. We view this aspect of our mission as complementary to our core
12 advocacy of investor interests. Continuing investment in essential, backbone
13 infrastructure is critical in support of a well-functioning and robust economy. In 2008,
14 AIC published "Infrastructure Needs and Funding Alternatives for Arizona: 2008-
15 2032" – a comprehensive study that examined infrastructure and funding requirements
16 over that 25-year period in four important areas: energy, water, telecommunications and
17 transportation. This report, prepared by economists from Arizona State University,
18 estimated investment requirements of about \$500 billion to meet our needs in these four
19 critical areas over the next two-and-one-half decades. The findings underline Arizona's
20 continuing need for (1) substantial capital attraction and (2) regulatory policies and
21 decisions which assist and support that capital attraction.

1 **Q. Please summarize AIC's interest in this case.**

2 A. Given our mission as the voice of investors, AIC's overriding interest in this case is to
3 help ensure that Tucson Electric Power Company ("TEP" or the "Company") can attract
4 capital on the best possible terms and rates for investment in Arizona's energy future. As
5 Mr. Bonavia discusses in his direct testimony, the Company can't continue the progress it
6 has made in strengthening its capital structure as well as its credit ratings "without the
7 rate relief supported by" TEP's Application.¹

8
9 **Q. What specific issue does your testimony address in this proceeding?**

10 A. The purpose of my testimony is to support the Company's request to implement an
11 Environmental Compliance Adjustor ("ECA").

12

13 **III. TEP'S PROPOSED ECA**

14 **Q. Mr. Yaquinto, please describe TEP's proposed ECA.**

15 A. Company witness Craig Jones discusses the ECA in greater detail at pages 62-64 of his
16 direct testimony and also provides a proposed ECA Plan of Administration as his
17 Exhibit CAJ-6. But, to summarize, TEP's proposed ECA is a rate mechanism that will
18 allow the Company to more timely recover the costs related to complying with various
19 environmental mandates imposed by governmental entities. Under the proposed ECA,
20 the Company would be allowed to recover (1) a return equal to TEP's Commission-
21 approved weighted average cost of capital ("WACC") on its Construction Work in
22 Progress, or CWIP, in ECA Qualified Investments and (2) after an ECA Qualified

23 ¹ Paul J. Bonavia Direct Testimony; July 2, 2012; pp. 10-11.

1 Investment is placed in service, a WACC return, together with depreciation expense,
2 income and property taxes, deferred taxes and tax credits where applicable and TEP's
3 O&M expenses.

4
5 **Q. Do you believe Commission approval of the proposed ECA is an appropriate,**
6 **essential and necessary component of this proceeding?**

7 **A.** Yes, for the following reasons:

8
9 First, the ECA allows more timely cost recovery on future emission control investments
10 which are mandated by the federal government and other jurisdictions. These are
11 investments over which TEP has no control.

12
13 Second, over the next five years, these investments will be very substantial – on the order
14 of up to \$400 million. To place that amount in context, this sum represents a huge
15 investment for TEP – roughly equal to almost one-fourth of its total current rate base.

16
17 Third, the substantial expenditures needed to complete these mandated investments will
18 occur over time between rate cases for the Company. This will cause a significant drag
19 on earnings and a substantial erosion of investor returns unless TEP is afforded an
20 opportunity to recover these costs in a more timely way. Given the very large magnitude
21 of these government-mandated environmental compliance costs, I believe the true
22 opportunity for TEP to earn its fair rate of return without the ECA is effectively nil.

1 **Q. Are there other reasons the Commission should approve the ECA?**

2 A. Yes. First, the ECA will provide TEP with cash flow to assist in financing the mandated
3 projects and, correspondingly, will help the Company maintain its credit ratings. That
4 results in lower financing costs over time, which are passed along to customers through
5 reduced upward pressure on rates.

6
7 Second, the ECA adjusts rates gradually as environmental compliance investments are
8 made by TEP, rather than postponing them for much larger and more abrupt recovery in
9 the Company's next rate case. The adjustor, therefore, will help to avoid what otherwise
10 will be very substantial rate spikes for consumers.

11
12 Finally, the gradual recovery of these costs through the ECA also reduces the need for
13 TEP to file rate cases as frequently as they'll be needed if a regulatory mechanism like
14 the ECA is not approved. These cases, of course, are expensive to process for the
15 Company, its customers, the Commission and stakeholder groups and those costs are
16 added to the tab consumers have to pay.

17
18 **Q. Are you aware of other instances where adjustors for environmental investments**
19 **have been approved by the Commission and other regulatory bodies?**

20 A. Yes. APS was authorized to implement an environmental cost adjustor several years ago
21 which was called the Environmental Improvement Surcharge ("EIS"). As originally
22 approved, APS was authorized to impose the surcharge and use its proceeds (subject to a
23 cap) directly to fund a portion of environmental projects' costs. In APS' last rate case

1 (Decision No. 73183; May 2012), the Commission granted APS a change in its EIS. The
2 change involved resetting the existing EIS rate to zero and initiating recovery of capital
3 carrying costs for investments made by APS for environmental controls through the EIS
4 once the projects are completed and placed in service. Although the mechanics of the
5 APS environmental surcharge are different from TEP's proposed ECA, the purpose of the
6 two mechanisms is the same – to provide more timely cost recovery support of
7 government-mandated environmental controls.

8
9 Additionally, environmental adjustment clauses or rate riders have been authorized in 27
10 states, including Arizona, for over 60 utility companies to more timely deal with the costs
11 of government-imposed environmental controls.² Further, a recent study by the Edison
12 Electric Institute indicates that environmental expenditures for the electric industry as a
13 whole could be as much as \$200 billion by 2015.³ Those high compliance costs and their
14 correspondingly large potential financial impacts on utilities are undoubtedly a primary
15 reason why many regulators have authorized adjustment clauses or rate riders for them.

16
17 **Q. You mentioned earlier that TEP is proposing that it be allowed to recover carrying**
18 **costs on CWIP through the ECA.**

19 **A. Yes.**
20
21

22 ² Regulatory Research Associates, Regulatory Focus, "Adjustment Clauses and Rate Riders: A State-by-State
Overview," March 2012.

23 ³ EEI study cited at page 25 of Jeff Guldner's January 18, 2012 Testimony in Support of Settlement Agreement;
Docket No. E-01345A-11-0224.

1 Q. Is it also your understanding that it is not standard practice for the Commission to
2 grant a return on CWIP?

3 A. Yes.
4

5 Q. Why, then, do you think it appropriate for the Commission to grant a return on
6 CWIP for these Qualified Investments in the ECA?

7 A. It's appropriate in this case for three reasons. First, as I mentioned previously, projected
8 expenses to meet environmental compliance mandates for TEP over the next few years
9 are huge in relation to its current rate base. These are costs that cannot be avoided and
10 their magnitude could, and likely will, jeopardize the Company's financial ratings if
11 provision is not made for their timely recovery. Allowing CWIP not only provides
12 timely recovery for the Company, it also reduces the amount of total project costs to be
13 recovered from customers. If these costs are, instead, accounted for employing an
14 Allowance for Funds Used During Construction, they will then be higher and eligible for
15 recovery over the life of the asset. That will continue to increase the impact on customer
16 bills far into the future.
17

18 Second, because these investments will be constructed over the next several years, absent
19 a CWIP allowance, TEP will need to file additional rate cases so as to timely rate base
20 these very large investments. Given the fact that the environmental projects covered by
21 the ECA are required by the government in order to continue plant operations, there's no
22 issue that TEP must comply and no controversy or concern that the investments are
23

1 useful or necessary. Requiring full, multiple rate cases in these circumstances truly
2 seems unnecessary, impractical and needlessly expensive.
3

4 Finally, these investments to meet environmental standards are not being made to expand
5 capacity in order to serve customer growth and, therefore, increase revenue. A previous
6 objection to the use of CWIP in Arizona has, in part, focused on projects related to the
7 construction of new capacity to serve growth. But, as Mr. Hutchens explains in his direct
8 testimony, this environmental equipment will actually reduce available plant capacity,
9 because it requires station power to function (Hutchens Direct Testimony, p. 25). Thus,
10 in this case, there are no offsetting increased sales to consider – only non-revenue
11 producing costs.
12

13 **Q. Is it your understanding that certain legal issues have been raised with regard to**
14 **CWIP in previous cases before the Commission?**

15 A. I am not a lawyer, but I am generally aware that legal concerns, which are unique to
16 Arizona, have been raised in past cases. I am also aware that other regulatory
17 commissions permit the use of CWIP in setting rates and that it is not an uncommon
18 practice elsewhere.
19

20 **Q. Should the Commission decide against the use of CWIP in the ECA or the ECA**
21 **generally, do you have another mechanism the Commission should consider?**

22 A. While the TEP proposal for the ECA is AIC's preferred approach to address these
23 Qualified Investments for the reasons I have discussed, as an alternative, the Commission
24

1 could allow this rate case to remain open following issuance of a final order to allow TEP
2 the opportunity to submit environmental compliance projects for rate base and return
3 inclusion once they have been placed in service. This is similar to the approach approved
4 by the Commission earlier this year for the APS Four Corners transaction. As I
5 understand it, it is also similar to a process followed to allow the timely rate basing of
6 large, required arsenic control investments for water companies. It would allow TEP to
7 bring projects as they are completed to the Commission for an authorization to place
8 them in rate base and to allow the Company, *inter alia*, to earn the Commission-
9 authorized rate of return on them without the need for a full rate case. While I consider
10 the ECA a preferable rate recovery and rate impact mitigation strategy, this "open
11 docket" approach is superior to the multiple and frequent standard rate case filing
12 solution.

13
14 **Q. Does this complete your testimony?**

15 **A. Yes.**
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